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SENSITIVE

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TAGS: ECON EFIN EINV ENRG ETRD KS
SUBJECT: KOREAN ECONOMY BEGINS TO SHOW FASTER-THAN-EXPECTED SIGNS OF IMPROVEMENT

¶1. (SBU) This cable is sensitive but unclassified and not rpt not intended for internet distribution.

¶2. (SBU) Summary: The Korean economy has proved more resilient than most think tanks expected during the steepest part of the global downturn in January and February. In the first quarter of 2009, the economy grew by 0.05 percent over the level of the fourth quarter of 2008 (when the economy declined by 5.1 percent). This apparently made Korea the only OECD economy to show positive growth - however negligible - in the first quarter. While the weak won and sharp decline of the Korean stock market were symptoms of the global financial crisis, the weak currency also helped buffer the economy by making Korean exports more competitive and imports more expensive. Thus, exports reached their nadir in January and began a mild recovery, while imports have continued to decline. The result has been increasingly large current account surpluses -- reaching USD 6.6 billion in March. Together with renewed inflows of foreign investment capital, these developments have helped the won recover over 20 percent of its value from its low approaching 1600 per U.S. dollar in early March. Korea's benchmark stock index has recovered even more strongly, rallying by more than 40 percent off of its early March low, one of the best global performances over that period. Capturing a mood of increasing if cautious optimism, U.S. economist Nouriel Roubini drew considerable attention when he told Seoul audiences on May 27 that he expected Korea's 2010 growth rate could come in above the 1.5 percent projected by the IMF (in February).

¶3. (SBU) While acknowledging that the Korean economy appears to be in a much better position than was predicted a few months ago, some economists remain concerned that the ROK economy is not as strong as recent developments may indicate. Some argue that the ROKG crisis measures -- the stimulation of the economy and stabilization of the financial system through the easing of monetary policy and the provision of liquidity to banks -- have created a situation of excessive liquidity. These economists believe that the ready availability of all this cash, particularly during a period when corporate facility investment has not recovered, makes the economy vulnerable to the development of new speculative bubbles. An alternate perspective holds that the impact of government measures will begin to dissipate during the third quarter of 2009 and that, given that external demand is likely to remain weak for Korean exports, the economy will experience a double-dip recession.

¶4. (SBU) A closer look at Korea's shipbuilding industry reveals both the strengths and vulnerabilities of the economy. The top firms are holding orders stretching over the next three years worth over USD 150 billion and experiencing very few cancellations. Newer SME shipbuilders have a much smaller order book, have experienced higher cancellations and are facing greater competitive pressures from China. More of these firms are likely to require restructuring or fall into bankruptcy as global demand for new ships remains anemic. The larger shipbuilders are well equipped to handle the downturn, but would be hurt if orders do not rebound within the next two years. End Summary.

¶5. (SBU) Recent developments with North Korea are not, at this point, expected to meaningfully affect South Korea's medium-term financial and economic performance. Following the North Korean nuclear test on Monday, May 25, the Korean stock market and won dipped initially but made back most of the losses. Markets closed Thursday, May 28, with the benchmark KOSPI stock index off less than one percent (0.6 percent) from its May 25 opening, and with the won similarly off less than one percent (0.6 percent) of its May 25 open.

ROK Economy Surprises with Slight Growth in Q1
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¶6. (SBU) The Korean economy, hit hard by the global financial crisis, experienced a GDP decline of 5.1 percent in the fourth quarter (Q4) of 2008. This was accompanied by 40 percent declines in the value of the Korean currency, the won, as well as Korea's

benchmark stock index, the KOSPI. Following some recovery in December, the currency and stock values began to decline again in January and February and some stories even surfaced in the international press (particularly in British publications) about the potential for sovereign default in Korea. For a time in February and March, each successive economic forecast projected a deeper decline in GSP in 2009 (the lowest was for a GDP contraction of 7.2). Yet, despite this clamor, in Q1 2009 ROK GDP actually posted a slight increase of 0.05 percent over the weak performance of Q4 of 2008 (but, of course, still 4.38 percent below the level of Q1 2008). This apparently made Korea the only OECD country to experience positive growth in the first quarter.

¶7. (SBU) The ROKG has taken a number of steps to ease monetary policy and stimulate the economy, but perhaps the biggest single contributing factor to this outcome was the unanticipated weakness of the won (driven principally by foreign portfolio investors pulling out of the Korean equity markets after September). Korean goods exports declined 34.8 percent in January, 19.4 percent in February, and 17.8 percent in March (all year-on-year), but the decline would have been considerably worse had the weak won not made Korean goods more attractive than those of competitors, especially Japan and China, in global markets. On the other side of the ledger, Korean goods imports declined by 31.9 percent in January, 30.6 percent in February, and 35.8 percent in March (all year-on-year), in part reflecting lower commodity prices compared with a year earlier. Services imports and exports followed a similar pattern, with Koreans dramatically curtailing other overseas travel and educational activities as the weak won made them unaffordable.

¶8. (SBU) Looking at components of growth, the steeper fall in imports than in exports (after January) generated a boost to net exports, which were 26.2 percent higher than in Q4 2008 and 67.2 percent larger than in Q1 2008. Government spending also played a role, increasing by 3.6 percent over the previous quarter. Private consumption was neutral, posting a 0.45 percent gain over the depressed Q4 2008 result (but 4.38 percent below the level of Q1 2008). Investment, on the other hand, continued to decline, dropping a further 12 percent after the already steep 16 percent decline in Q4 2008.

Monetary and Financial Stabilization

¶9. (SBU) The gradual easing of the global credit crunch in Q1 2009 provided room for improvement in the stability of the ROK financial system. This was not immediately apparent as the won renewed in January and February its fall against the dollar, reaching a low of nearly 1600 per dollar on March 3. As markets became concerned with the potential for sovereign defaults in Eastern Europe, speculation increased regarding the possibility that Korea was also vulnerable, with some (superficial) analyses focusing on Korea's relatively high short-term foreign currency debt. However, much of that debt is currently held by international commercial and investment banks operating in Korea and is owed to their headquarters - an internal corporate transaction considered unlikely to lead to defaults (unlike in the 1997/98 financial crisis, when Korea's high foreign currency debt was held by over-extended chaebol conglomerates).

¶10. (SBU) While a scenario involving ROK sovereign default may have seemed plausible in February under worst-case assumptions, the situation changed rapidly and the won began to strengthen substantially in March. The prevailing outflow of foreign funds out of Korea reversed course and became a rapid inflow into Korean stocks and bonds. The impact of the weak currency on trade also made itself felt as the current account, which posted a USD 1.64 billion deficit in January, surged into the black in February and March with surpluses of USD 3.56 billion and USD 6.65 billion, respectively. The April trade surplus of USD 5.8 billion exceeded that of March and initial indicators point to continuation of the trend in May. These factors have supported a 20 percent rise in the value of the won and a 40 percent increase in the value of the benchmark KOSPI stock index (from their 2009 lows of early March). Foreign reserves

have also begun to climb, rebounding from USD 201 billion at the end of February to USD 212 billion at the end of April.

¶11. (SBU) The ROKG has undertaken many policy actions since mod-October to increase the stability of the financial system. These measures, facilitated by the improving global financial environment, have had a positive impact. The Bank of Korea (BOK) has undertaken the most aggressive monetary easing measures in its entire history. The policy interest rate was slashed from 5.25 percent to 2 percent (although the BOK has signaled that further cuts are unlikely barring unexpected financial system deterioration). The BOK has also used various tools to inject liquidity into the banking system, to assist with bank recapitalization, and to support the bond market. These BOK measures were accompanied by a broader ROKG shift to massive fiscal stimulation of the economy with additional spending and tax cuts between Q4 2008 and into 2010 totaling 7.4 percent of GDP.

¶12. (SBU) Additional measures taken include guarantees of SME debt and ROKG purchases of construction-related debt and assets. Planned actions include the creation of funds to support construction, shipbuilding and shipping sectors (including through the purchase of idle assets, such as ships). The positive impact of this set of measures can be seen in reduced spreads (differences) between Korean Treasury bonds and those of banks and larger firms, in reduced numbers of bankruptcies, and in a radical improvement in the ability of Korean banks to roll over debt and issue foreign currency-denominated bonds (Korean banks raised over USD 12 billion in new capital in overseas markets in the first five months of 2009).

¶13. (SBU) The BOK has indicated that the banking system's liquidity situation has improved markedly and that capital adequacy ratios remain in solid territory. The BOK has, however, acknowledged some deterioration in the soundness of the commercial banks because of a sharp contraction in profitability. This view was seconded by the one-notch downgrading by Moody's in mid-May of the creditworthiness of Korea's major commercial banks. Household debt has increased relative to income and financial assets, but this has been offset by lower interest rates. Real estate prices have continued to decline through Q1 2009, but the lower loan-to-value ratios required in Korean real estate financing have thus far ensured that home values continue to exceed loan values.

Some Wonder: Too Much of a Good Thing?

¶14. (SBU) There is general acknowledgement among economists in Korea that the Korean economy appears to be in a much better position than was predicted a few months ago. However, the very success of the government's stimulus measures, together with the strong rebound of the Korean stock market, have led some economists and investors to question whether the ROKG has injected too much liquidity into the financial system. One economist claimed that over 800 trillion won (or USD 623 billion) is floating freely in the Korean market, a ready supply of hot money that could flow rapidly between investments in a potentially destabilizing search for higher returns. Similar analyses have highlighted concerns about the possibility of liquidity-induced speculative bubbles developing within the economy.

¶15. (SBU) One senior investment banker argued a somewhat different unpleasant scenario for the near future of the economy. He suggested that the surging price of stocks (both in Korea and globally) is a symptom of a classic bear-market rally. In this view, the Korean market has been buoyed by the weakness of the currency, by the low interest rates, by the additional liquidity and by the fiscal stimulus measures. All of these effects were strong in Q1 and carry some momentum into Q2 but they will begin to dissipate during Q3. Global demand will remain sluggish throughout 2009 and thus the Korean economy will have nowhere to go but down, resulting in a double-dip or W-shaped recession.

¶16. (SBU) Economists and market analysts have pointed to other areas of concern as well. Some argue that corporations are resisting bank-led restructuring efforts to avoid selling core assets. This argument does not really apply to the top ten conglomerates, which learned during during the 1997/98 financial crisis to hold onto cash (most have low debt rates below 100 percent). The main concern in this regard is Korea's second-tier conglomerates (which are not generally as successful in export markets), as well as large firms that sought to expand through high-priced leveraged buyouts of other firms (Doosan Infracore, STX Shipbuilding, and Kumho Asiana group, all of which embarked upon transformative acquisitions in recent years, are the Korean companies most prominently mentioned in this regard). Banks too are said to be hesitant to write down assets in the present environment, hoping for further improvement in business conditions and market prices. Another concern is that the financial sector remains vulnerable to an external shock, possibly through the outstanding SME loans that have been rolled over or possibly even through foreign investor-led short-selling of Korean stocks.

Shipbuilding - A Critical Sector

¶17. (SBU) The shipbuilding industry has become increasingly important within the ROK economy. The industry accounted for 10.2 percent of Korean exports in 2008 and, accounting for approximately 5 percent of GDP, was Korea's single biggest industry (and the largest shipbuilding industry in the world). Shipbuilding is one of a small group of industries with a considerable lag (three-or-so years) between the time an order is received and the product is finished and delivered. Payments are generally spread across this period in five equal increments. The shipbuilding firms book the payments as liabilities rather than income until the completion of the order. Since prices are set in dollars but most costs are in won, firms take futures currency contracts to hedge against the risk of exchange rate fluctuations.

¶18. (SBU) Shrinking global trade during the economic slowdown has led to dramatic declines in demand for new ships, and many orders for lower-end vessels, especially bulk carriers, have been cancelled. Korean shipbuilders currently have an order book (backlog of orders) worth approximately USD 200 billion. The top three Korean shipbuilders account for approximately 83 percent of these backlogged orders. The Korean industry is structured toward high-end vessels such as large container vessels, chemical carriers, and specialty vessels designed for various functions within the oil industry. Thus, while China has reportedly experienced the

cancellation of about 200 vessels, Korea has suffered the cancellation of only around 20 vessels (worth approximately USD 1 billion).

¶19. (SBU) The Korean industry has had a significant number of new entrants in recent years, particularly SME enterprises involved in construction of lower-end vessels, an area where competition from China is particularly strong. SMEs account for approximately two-thirds of Korean shipbuilders but only 30 percent of the value of the contracts. With no new orders, smaller order backlogs, shorter lags between orders and completion, and the burden of cancellations falling disproportionately on these firms, it is not so surprising that analysts are concerned about the solvency of Korea's SME shipbuilders. Yet only a few of these firms have been pushed into the bank-led restructuring program. Additional restructuring or bankruptcies are likely among these smaller Korean shipbuilders in the near term as global demand for new ships is estimated to be depressed for at least several more quarters. However, the larger shipbuilders are well positioned to weather the storm provided that orders begin to pick up within the next two years. The longer term issue for the industry is how to maintain competitiveness against the Chinese shipbuilders.

Comment

¶20. (SBU) The ROKG has scored success through its efforts to

stimulate the economy, stabilize the financial system, and insulate vulnerable sectors from the impact of the financial crisis and global downturn. The weakness of the currency, which came as a result of the vulnerability of the Korean financial system to global developments - most notably foreign investors repatriating capital to U.S., EU and other markets -- also ended up buffered the economy from further harm. The downside risks to the economy are many, and the ROKG seems to be well aware of these and is developing methods to identify, track, and respond to them. Finance Minister Yoon Jeung-hyun was quoted in early May in response to the excess liquidity argument, "We recognize the concerns, but now is not the time to absorb liquidity." Yoon has repeatedly made clear that the government is concerned that withdrawal of its ample support for the economy would be premature at this point. Instead the ROKG has indicated that it is prepared to fine tune economic policy to prevent the emergence of speculative bubbles within the economy, e.g., to make real estate speculation in the most desirable Seoul neighborhoods more expensive. While the Korean economy has proven to be more resilient than its critics believed possible, ROKG policy makers face many constraints and are unlikely to be able to maintain economic growth unless global demand begins to recover

STEPHENS